KY COURSE 80: RESIDENTIAL REAL PROPERTY APPRAISAL
First Day Reading Assignment
Rev. 2010

CHAPTER ONE

APPRAISAL THEORY

A. Appraisal and Assessment

The duties of the property tax assessor involve much more than the appraisal of individual properties, but the basic theories of the appraisal process are extremely important to the assessor. The reason is quite simple. The value of real property continues to grow. Over the past 25 years, the real property assessment base in Kentucky has grown by an average of seven percent each year. Of the $216 billion in real property assessed in 2009, over $144 billion, or 67%, was residential property. The percentage has changed somewhat over the years, but it has always been at a level where it can be said that the valuation of residential real property is one of the more significant tasks of the PVA office.

An appraisal must be made on each parcel of real estate to determine its taxable assessment. An *appraisal* may be defined as an opinion, or an estimate of value. The valuation of real property is not an exact science. An accurate and reliable appraisal depends upon the reliability of data used by the assessor and by the soundness and skill with which the assessor processes that data. Therefore, not only is the valuation of real estate the largest job facing assessors, it is probably their most complex task.

The fee appraiser working in the marketplace has the luxury of spending a reasonable amount of time appraising an individual property. The fee appraiser is then able to assemble the information into an appraisal report. This report is a detailed document supporting the estimate of value of a single property.

On the other hand, property tax assessors must appraise a large number of properties in a short period of time, using a process known as *mass appraisal.* The concept of mass appraisal involves applying one or more of the three approaches to value to more than one subject property; in practice, this typically means hundreds or thousands of subject properties. The goal of fair market value remains the same. Instead of applying to only one appraisal, however, it must prevail over a broad spectrum of properties representing all ranges of sizes, age and quality within the jurisdiction. Mass appraisal procedures must employ a consistent methodology, be based on dependably accurate data, and be evaluated through the use of standard statistical testing methods, in order to ensure adherence to the fair market value standard. The scope of this task precludes the possibility of preparing detailed appraisal reports for each property. However, the necessity of following the steps of the appraisal process is still valid.

Property tax assessors generally examine major factors which influence value in arriving at assessments. No appraiser can consider every factor which could slightly affect the estimate of market value. But through statistical analysis of sold properties, an assessor can identify those factors which exert the greatest influence on the variation in sale prices for an area, and use those factors in the mass appraisal process.

B. Real Property

Kentucky Revised Statute (KRS) 133.010 (3) provides a simple and concise definition of real property:

> *"'Real Property' includes all lands within this state and improvements thereon."*

Real property may be defined as the sum of the tangible and intangible qualities of land and improvements. It refers to the interest, benefits, and rights inherent in the ownership of physical real estate.

There are six basic rights associated with the ownership of property. These are derived from obtaining *fee simple title* to a piece of property. Fee simple title is ownership that is free and clear of all encumbrances, including easements, rights of way, liens, and so forth. The bundle of rights may be compared to a bundle of sticks, with each stick representing ownership of one property right. The basic rights of ownership are:

1. The right to use the property.
2. The right to sell the property.
3. The right to lease or rent the property.
4. The right to enter or leave the property.
5. The right to give away the property.
6. The right to refuse to utilize any of the above rights.

Property ownership may be transferred with or without all of these rights being exchanged.

Real estate may be divided into two categories: *land* and *improvements*. Land may be defined as the surface of the earth together with everything under its boundary and everything over it extending indefinitely into the air. Improvements are items permanently affixed to and becoming part of the real estate. The concept of *permanently affixed* is related to the economic life of the improvement.

Two basic tests can be used to determine if an item is permanently affixed to the land and should be considered to be real property. These tests are: (1) the intention of the person who put the item in its place, and (2) whether the item may be removed from the real estate without damaging either the item or the real estate.

C. Fair Cash Value

The primary duty of the Property Valuation Administrator (PVA) is to equitably assess the value of real and personal property. Section 172 of the Constitution of Kentucky requires that:

> *"All property, not exempted from taxation by this Constitution, shall be assessed for taxation at its fair cash value, estimated at the price it would bring at a fair voluntary sale."*

This language has not been amended since the current (Kentucky's fourth) Constitution was adopted in 1891.

KRS 160.460, enacted as part of the Kentucky Education Reform Act, states:

> *"…all real property located in the state and subject to local taxation shall be assessed at one hundred percent (100%) of fair cash value."*

These mandates, backed up by the historic (1965) *Russman v. Luckett* decision, establish the fair value standard as law in Kentucky.

For the purposes of assessment administration in Kentucky, "market value" and "fair cash value" should be considered synonymous. Market value is defined by the International Association of Assessing Officers (IAAO) in Property Appraisal and Assessment Administration (1990) as follows:

> *Market value is the most probable price in cash that a property would bring in a competitive and open market, assuming that the buyer and seller are acting knowledgeably, sufficient time is allowed for the sale, and price is not affected by special influences.*

The Appraisal Foundation, in its Uniform Standards of Professional Appraisal Practice, defines market value as:

> *The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:*
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> 1. *buyer and seller are typically motivated;*
> 2. *both parties are well informed or well advised, and acting in what they consider their best interests;*
> 3. *a reasonable time is allowed for exposure in the open market;*
> 4. *payment is made in terms of cash in United States dollars or in terms of financial arrangements comparable thereto; and*
> 5. *the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.*

Obviously, the most reliable indicator of market value for a particular parcel of property is a recent sale price that meets the criteria established above. In the absence of a recent arms length transaction, the PVA must establish the fair cash value based on the most probable price a willing buyer would pay a willing seller, provided both parties are fully informed and act voluntarily. This hypothetical sale price, or value, must be derived through the use of standard appraisal practices. Every effort should be made to arrive at a fair assessment, as "any grossly discriminatory valuation shall be construed as an intentional discrimination." (KRS 132.450) The necessary information needed for an appraisal can be gathered through visits with the taxpayer, property tax returns, inspection of the property, deeds and records, and from any other source the PVA may be able to obtain, including from the PVA's personal knowledge.

The understanding of an arm's-length transaction is crucial to grasping the concept of market value. There are several requirements for a sale to be considered an arm's-length transaction. These requirements are:

1. A willing buyer and a willing seller. Neither may be acting under duress with no advantage being taken by buyer or seller.
2. Property must be marketed for a reasonable amount of time to locate a willing buyer.
3. Both buyer and seller must be informed and knowledgeable about the property and its potential.
4. No unusual circumstances may be present in the transaction.

Implicit in the foregoing definitions is the fact that careful analysis of sales is a prerequisite to any appraisal, whether as a single subject or in the mass appraisal environment.

D. Classes of Property

For purposes of valuation and assessment in Kentucky, real property is divided into three classes.

Parcels comprising ten or more acres whose primary use is for agricultural production are considered to be farm property. While the land and income producing improvements of farm property are assessed at agricultural value, the residence and surrounding yard space are assessed at fair cash value. Commercial and industrial property, like farm property, produces an income stream for the owner.

Residential property is composed of small parcels, including improvements, whose highest and best use is as a place to live. Mobile homes are considered to be real estate in Kentucky, unless held for resale by a dealer, and are primarily used as residential property. Duplexes and single family dwellings converted to multiple family use are generally classified as residential property. Individual condominium units are also classified as residential property. Four-plexes and buildings with higher numbers of units are generally assessed as commercial property. The scope of this course includes the appraisal of residential property only.

CHAPTER TWO

DUTIES OF THE PROPERTY VALUATION ADMINISTRATOR

A. Constitutional and Statutory Requirements

The Property Valuation Administrator (PVA) is responsible for discovering, listing, and valuing all property within the borders of a county. Furthermore, the PVA has a responsibility to the individual property owner to ensure that no more than a fair share of property tax, based on an equalized assessment, is paid. This is accomplished by assessing all property at its fair market value. The PVA is responsible to all constituents in ensuring that no property escapes the assessment process or is underassessed and that no property owner receives unauthorized preferential treatment.

The property tax is an *ad valorem* tax, which means "according to value". The tax levied to a property owner is based solely upon the value of the property (multiplied by the appropriate combination of tax rates). It is based neither upon the ability of the owner to pay nor upon the amount for which the property last sold if that sale price was not an accurate reflection of fair market value.

KRS 132.190 specifies the property that is subject to taxation, in addition to re-emphasizing the fair cash value mandate and liability for taxation. This statute states that:

> *(1) All property shall be subject to taxation, unless it is exempted by the Constitution or in the case of personal property unless it is exempted by the Constitution or by statute.*

KRS 132.690 requires that all property be physically examined by the PVA no less than once every four years. This statute also requires that the PVA submit a schedule to the Office of Property Valuation specifying the time in which the quadrennial inspections are to be accomplished, and that records of inspections and revaluations for each parcel be maintained.

The quadrennial inspection plan was challenged in court in the case of Leary v. Franklin County PVA. Taxpayer Joe Leary argued that the four year inspection/reappraisal method employed by the Franklin County PVA (and other PVAs in general) was discriminatory and unconstitutional. The Kentucky Court of Appeals ruled in Revenue Cabinet v. Leary that the four year inspection and assessment review method required in KRS 132.690 was legal. The State Supreme Court denied a motion for discretionary review, effectively making the Court of Appeals' decision final.

The Court of Appeals wrote:

> "In evaluating whether a quadrennial plan is arbitrary or intentionally discriminatory, all relevant circumstances should be considered, including the limitations of time and staff, the nature and extent of existing inequities in the tax rolls, the extent to which such existing inequities are rectified by the plan, the amount and duration of the temporary disparities under the plan and whether non-implementation of the plan would perpetuate existing inequities."

As a result of this ruling, the Office of Property Valuation required all PVAs to file a quadrennial review plan which addresses these issues while outlining the plans for the physical inspection of all property over the four year period.

Specifically, each PVA is required to document why the inspection plan submitted is applicable and how it addresses the most severe assessment problems first. Also, the PVA's plan must estimate the total number of parcels in the county as well as the number to be examined each year. Staff members who will conduct the physical review must be identified and an estimation of the time required to complete the review annually must be given.

The following guidelines should be used by all PVAs to ensure compliance with the quadrennial inspection requirement:

1. The field review must check, verify, and correct property records. This means that maps and property records (preferably on a laptop computer) must be taken to the field for the actual review process.

2. The review must discover and note new improvements and additions to existing improvements. New photographs should be taken as needed. Property characteristics (such as building sketches, square footage, and other information) must be reviewed and updated or corrected as necessary.

3. Any omitted real property (either land or improvements that were not on the tax roll) must be documented. The omitted billing process must be initiated.

4. The assessment of each parcel of property must be reviewed. If the assessment appears to be appropriate, it is not necessary to change it. If the assessment is too high, it must be lowered. If the assessment is too low, it must be raised. The standard is annual reassessment at 100 percent fair cash value.

5. A record must be kept of the date of physical inspection. This may be done on individual cards, on a folder if folders are kept for each parcel, or in a computer system as long as an individual notation can be made for each parcel. An advantage of digital photography is that most cameras will record the date on the photograph or write it to the file.

Further information regarding the duties of the PVA with respect to the assessment of residential real property is contained in the <u>Assessment Administration Manual</u>: <u>Office</u>

of the Property Valuation Administrator, published by the Office of Property Valuation.

B. Court Rulings

Various court cases over the years have clarified the duties and responsibilities of the assessor in Kentucky. But no court case has had more impact on the property tax system than the landmark Russman v. Luckett decision in 1965. In Russman v. Luckett, the Kentucky Court of Appeals reaffirmed the fair cash value standard set forth in Section 172 of the Constitution. Prior to that time, assessment levels in the counties were typically 15% to 40% of fair market value. Serious equity problems arose from this previously accepted practice. In the year following the Russman v. Luckett decision, the statewide real property assessment base increased from $3.1 billion to $11.8 billion. In response to this 270% increase, the state real property tax rate was lowered from 5¢ per $100 to 1.5¢ per $100, and local property tax rates also declined. In 1981, the Kentucky Supreme Court ruled in Butler v. Allphin that all property must be valued at its fair cash value by the Property Valuation Administrator (KRS 132.450).

A lawsuit filed by approximately 67 school districts across the state which challenged the method of funding schools was the impetus for the passage of the Kentucky Education Reform Act (KERA) in 1990. In Rose v. Council for Better Education the Kentucky Supreme Court wrote:

> "The General Assembly must provide adequate funding for the system. However, if ad valorem taxes on real and personal property are used by the General Assembly as part of the financing of the redesigned state system of common schools, the General Assembly has the obligation to see that all such property is assessed at 100 percent of its fair market value."

KRS 160.460 further defines the requirements of fair cash value set forth in the Constitution. It requires PVAs to better monitor conditions throughout the county to ensure that their constitutional duties are being met. The Leary case noted that a parcel of property would not be revalued in a non-examination year only if the PVA had been unable to obtain updated information about it which would indicate a change in valuation was warranted. In other words, if a PVA received updated information about a property outside of the quadrant under examination, a change in valuation must be made even in the non-examination year if one is found to be needed. The updated information usually consists of a deed of sale or a building permit noting a significant improvement.

C. Listing Process

KRS 132.220 states:

> *(1)(b) It shall be the duty of the holder of the first freehold estate in any real property taxable in this state to list or have listed the property with the property valuation administrator of the county where it is located between January 1 and March 1 in each year...*

This statute removes the listing requirement for those who purchased property during the preceding year for which a value was stated in the deed and those whose property was correctly and completely described in the assessment record for the previous year. The listing requirement specifically applies to all persons who have changed their real estate in some way that could potentially affect the assessed value during the preceding year.

In reality, few people actually list their property annually with the PVA; however, it is important to be aware of the requirements of the listing statutes. The fact that the owner or anyone “having any interest” in the property must list the property allows the PVA to know in whose name the property assessment should be made. All real property must be assessed, even if the PVA is unable to determine the ownership. In the unlikely event that this occurs, the property must be assessed to "unknown owner", according to KRS 132.220 (4).

The PVA may require any real property owner to submit a property tax return to verify existing information or to provide additional information for assessment purposes. The PVA may (and should) ask for property characteristic information when the taxpayer lists the property. KRS 132.230 requires that:

> *(1) Every person listing his property with the property valuation administrator shall state:*
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> *(a) Each separate tract of land, with the number of acres in each tract; the value per acre; each of the improvements thereon; the name of the nearest resident thereto; where located, giving the election precinct in which it is located; the number of each city lot and the improvements thereon, in what city, on which street, the value of each, and the value of the improvements thereon to the extent that they enhance the value of each lot...*

All completed returns should be audited by the PVA or office staff for completeness and accuracy. The PVA is not merely a "list taker". The duty of assessing property at its fair cash value, uniformly and equally among all taxpayers, requires observation and analysis independent of the listing process. Therefore, it is not feasible to assume that values listed by taxpayers are accurate. Listed information certainly is a valuable source of information, but it should not be accepted as the assessment for the property until an analysis is done and the taxpayer's renderings are proven to be accurate.

KRS 132.220(3) states that the PVA, deputies, or employees of the Department of Revenue may physically inspect and revalue land and buildings in the absence of the property owner or resident. The exterior dimensions of the buildings may be measured and building photographs may be taken. This provides the PVA the statutory authority to verify information supplied by the taxpayer.